IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

UNITED STATES OF AMERICA,
Petitioner,

vs.

NEIL T. NAFTALIN,
Respondent.

No. 78-561

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Statutes and Regulations:

Miscellaneous:

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Respondent, for the reasons stated herein, prays that the Court deny Petitioner's request for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this matter.

QUESTION PRESENTED

Whether Section 17(a)(1) of the Securities Act of 1933 prohibits the short sale of securities where the seller fails to disclose the sales are "short" or misrepresents the sales as "long" to brokers acting as agents for the seller, and where the investors who purchase the sold securities are neither deceived nor damaged.

STATUTES INVOLVED

1. Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. §77q(a)(1), provides in part:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud . . .

2. Section 2(3) of the Securities Act of 1933, 15 U.S.C §77b(3) provides in part:

> The term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term . . . "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.

STATEMENT OF CASE

In 1969 Respondent was the principal of a registered broker/dealer who allegedly engaged in a fraudulent scheme by placing orders with five different brokers in eight separate transactions to sell stock listed on the New York Stock Exchange. Allegedly Respondent did not own such stock at the time of the orders and was selling "short" either without disclosing such fact or by misrepresenting that the sales were "long" to the brokers.[1] The brokers were acting as Respondent's agents for the purpose of

[1]A "short sale" means any sale of a security which the seller does not own. Rule 3b-3, 17 C.F.R. §240.3b-3. A "long sale" by general usage is considered to be a sale of a security which the seller owns.

finding buyers for the stock and transferring the stock to them (Petition, App. A, 2a).[2]

It had been Respondent's practice to deliver securities to his brokers weeks or months after the settlement dates for his sales (Petition, App. A, 3a).[3] When Respondent would not deliver the sold securities by their settlement date his brokers would nevertheless make delivery to purchasers of the securities by borrowing or purchasing the securities.[4] By permitting such delays while they covered Respondent's sales, the brokers were extending credit to Respondent and were very likely violating Section 7(c) of the Securities Act of 1934 (the "1934 Act"), 15 U.S.C. §78g(c), and Regulation T, 12 C.F.R. §220.1, promulgated thereunder by the Board of Governors of the Federal Reserve Board.[5]

[2]Count VI of Respondent's indictment related to sales to a brokerage firm acting as a principal on its own behalf. Count VI was dismissed by the Eighth Circuit because it did not charge that Respondent had defrauded any purchasers". Petitioner has not raised the dismissal of Count VI on this ground as a question presented for review.

[3]*Naftalin & Co., Inc v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166, 1175 n. 10 (8th Cir. 1972).

[4]*Id.* at 1171.

[5]*Id.* at 1176.

Section 7(c) provides in part:

> It shall be unlawful for . . . any broker or dealer, directly or indirectly to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—
>
> (1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section. . . .

Respondent's sales were transacted through "special cash accounts" with his brokers. Under Regulation T sales in such accounts may be made only if the sold securities are already held in the customer's account or if in good faith the broker/dealer believes the securities will be promptly delivered to the account. Specifically, Regulation T states that a broker/dealer may in a special cash account:

such an account:

> Sell any security for . . . a customer provided the security is held in the account or the [broker/dealer] is informed that the customer or his principal owns the security and the . . . sale is in reliance upon an agreement accepted by the [broker/dealer] in good faith that the security is to be *promptly* delivered in the account.

12 C.F.R. §220.4 (Emphasis added).

Ultimately, Respondent never delivered to his brokers any stocks for the sales which were the basis of Respondent's indictment. The Circuit Court below found that the indictment transactions resulted in loss to Respondent's brokers.[6] However, all investors who purchased stock sold by Respondent received such stock and there was no evidence that any third party investors were deceived or defrauded in any way (Petition, App. A, 5a). The Eighth Circuit further found that as between Respondent and the brokers there were no offers or sales of securities. (Petition, App. A, 6a).

Respondent disclosed to the brokers and the Securities and Exchange Commission (the "SEC") in October, 1969, that Respondent was unable to deliver the stocks he had sold. Thereafter occurred an outrageous delay of four and one-half years[7] before Respondent was indicted under Section 17(a)(1) of the Securities Act of 1933 (the "1933 Act"). During this hiatus the government, through the SEC, participated in various proceedings related to Respondent's alleged short selling.[8] Due to such delay the trial

[6] After Respondent's disclosure of his inability to deliver stocks pursuant to his sell orders, the brokers themselves purchased the particular stocks and suffered losses due to rises in the market for such stocks since their dates of sale.

[7] *United States v. Naftalin*, 534 F.2d 770, 771 (8th Cir. 1976).

[8] The indictment transactions have been part of the subject matter of (1) a civil injunctive action (*SEC v. Naftalin & Co., Inc.*, 4-69 Civ. 385 (D. Minn. November 9, 1969); 460 F.2d 471 (8th Cir. 1972)); (2) involuntary bankruptcy proceedings (*In Re Naftalin & Co., Inc.*, 4-70 Bky. 137, 170 (D. Minn. February 10, 18, 1970); 315 F. Supp. 463 (D. Minn. 1970); 333 F. Supp. 136 (D. Minn. 1971); 469 F.2d 1166 (8th Cir. 1972)); (3) private civil actions (*H. S. Kipnis & Co. v. Naftalin & Co., Inc.*, 4-70 Civ. 408 (D. Minn. October 1, 1970); *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Naftalin & Co., Inc.*, 4-70 Civ. 458 (D. Minn. October 23, 1970); *Faulkner, Dawkins & Sullivan v. Naftalin & Co., Inc.*, 4-71 Civ. 33 (D. Minn. January 29, 1971)); and (4) SEC disciplinary proceedings (*In the Matter of Naftalin & Co., Inc. and Neil T. Naftalin*, SEC File No. 3-3272 (September 30, 1971)).

court dismissed Respondent's indictment. On appeal to the Eighth Circuit, however, the indictment was reinstated.[9]

Finally, a jury having been waived, this matter was heard in December, 1976 and Respondent convicted on all indictment counts. On appeal to the Eighth Circuit, Respondent's indictment was dismissed in its entirety. The Court reasoned that the "species of fraud" of which Respondent was accused was not prohibited by Section 17(a)(1). The court concluded that under such statute "the government must prove some impact of the scheme on an investor" (Petition, App. A, 8a).

REASONS FOR DENYING WRIT

Petitioner attempts to dignify the narrow issue presented in this matter by casting it as one potentially affecting all "intermediaries" in securities transactions and as one "essential to the securities marketplace" (Petition at 6). Such largess in characterization of the issue is belied by the fact that in the forty-five years since enactment of Section 17(a) this case is apparently the first reported decision in which the issue, even as framed by the government, has been directly confronted.[10] When the issue is properly framed as merely involving the question of whether Section 17(a)(1) proscribes nondisclosures or misrepresentations to a seller's own agent concerning short sales, in the absence of actual or intended injury to investors, the true ramifications of this matter are revealed.

[9] *United States v. Naftalin*, 534 F.2d 770 (8th Cir. 1976) *cert. denied* 429 U.S. 827 (1977).

[10] Petitioner's contention that the decision below is in conflict with *United States v. Brown*, *infra* is wholly unsupportable as discussed *infra*.

A. Jurisdiction of this Court is Sought Merely to Rectify the Government's Error in Bringing Respondent's Indictment Under the Wrong Statute.

This matter is before the Court solely due to a mistake of the government—a mistake apparently born of belated haste to bring an indictment against Respondent prior to the running of a statute of limitations.[11] Simply stated, the government selected the wrong federal securities statute under which to bring Respondent's indictment.

At the time of Respondent's indictment it was well recognized that Section 10(b) of the 1934 Act, 15 U.S.C. §78j(b) and Rule 10b-5, 17 C.F.R. §240.10b-5 promulgated thereunder, offered more expansive prohibitions on fraud and deception.[12] In particular, the stage had already been set for a possible criminal indictment of Respondent under these provisions by the government's successful prosecution in *United States v. Peltz,* 433 F.2d 48 (2d Cir. 1970). There a conviction was upheld under Section 10(b) and Rule 10b-5 based on the defendant's false statements to brokers that his stock sales were long when in fact he was selling short.

At the time of Respondent's indictment, authority also existed under which the government might well have chosen to indict Respondent for a violation of Section 10(a) of the 1934 Act, 15 U.S.C. §78j(a), or rules thereunder, which expressly regulate short selling.[13] *See United States v. Peltz, supra* at 54; *see also United States v. Mandel,* 296 F.Supp. 1038 (S.D.N.Y.1969).

[11] See *United States v. Naftalin,* 534 F.2d 770, 772 (8th Cir. 1976).

[12] Section 10(b) of the 1934 Act states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, promulgated under Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

B. Respondent's Indictment Is Based On Stale Factual Events Unlikely of Repetition.

This matter is now one of only historical interest, and one turning on unique facts involving sophisticated brokers who, if not in actual violation of the credit extension provisions of Regulation T, at least had far less than clean hands.[14] More than nine years have passed since the indictment transactions and there is a decided staleness about this matter. This is especially true in view of subsequent securities regulations which have substantially eliminated the probability that events similar to those giving rise to Respondent's indictment will be recurring.

Specifically, it should be understood that Respondent's

[13] Section 10(b) of the 1934 Act provides in part:

> It shall be unlawful for any person . . . .
>
> (a) To effect a short sale . . . of any security registered on a national securities exchange, in contravention on such rules and regulations as the Commission may prescribe . . . .

[14] *See Naftalin & Co., Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., supra.*

brokers were damaged due to their own tardiness in covering Respondent's sales.[15] Since the time of Respondent's transactions, Rule 15c3-3(m), 17 C.F.R. §240.15c3-3 (m), has been adopted by the SEC. This rule now requires a broker/dealer to buy-in for the account of a seller if within 10 business days after settlement date for a sale the broker/dealer has not obtained possession of the sold securities "for any reason whatsoever".

In the intervening years additional regulations directed against transactions such as those attributed to Respondent have been enacted and promulgated in the form of Section 7(f) of the 1934 Act, 15 U.S.C. §78g(f), and Regulation X, 12 C.F.R. §224.1. These provisions make it unlawful for a customer to obtain extensions of credit from a broker/dealer in contravention of Regulation T.[16]

C. Other Effective Remedies Are Available for Deceptive Short Selling Which Damages Brokers of the Seller.

Petitioner argues that an expansive reading of Section 17(a)(1) beyond its intended scope is necessary in order to

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[15] *Id.*

[16] Prior to Regulation X only brokers/dealers had the "onus of complying" with Regulation T. *Naftalin & Co., Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., supra* at 1182.

Section 7(f) of the 1934 Act states in part:

> It is unlawful for any United States person . . . to obtain, receive or enjoy . . . extension of credit from any lender . . . for the purpose of (A) purchasing or carrying United States securities, if under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited . . . .

Regulation X, promulgated under Section 7(f), states in part:

> §224.2(a) A borrower shall not obtain any purpose credit from within the United States unless he does so in compliance with the following conditions:
>
> . . .
>
> (2) Credit obtained from a broker/dealer shall conform to the provisions of Part 220, (Regulation T) . . . .

supply the SEC with effective armament. Such argument should have a familiar ring. In *SEC v. Sloan*, —, U.S. —, 56 L.Ed.2d 148 (1978), the Court rejected a similar argument that Section 12(k) of the 1934 Act, 15 U.S.C. §781(k), should be interpreted beyond its language and intent in order to allow the SEC to issue successive trading suspension orders. The SEC argued that other remedies available to it were ineffective. Such position, however, was chastized and aptly characterized by the Court:

> Even assuming, however, that a totally satisfactory remedy—at least from the Commission's viewpoint—is not available in every instance in which the Commission would like such a remedy, we would not be inclined to read §12(k) more broadly than its language and the statutory scheme reasonably permit. Indeed, the Commission's argument amounts to little more than the notion that §12(k) *ought* to be a panacea for every type of problem which may beset the marketplace.

Id. 56 L.Ed.2d at 1160.

In addition to possible enforcement actions now available under Section 7(f) of the 1934 Act against a seller unlawfully obtaining credit from a broker in a short sale, as noted above, enforcement is also available under Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. *United States v. Peltz, supra.* As admitted by Petitioner, these provisions have already been recognized to protect more than investors (Petition at 9, n. 10). *See A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 396-397 (2d Cir. 1967). This Court in *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6, 12 n. 8 (1971) expressly noted that the legislative history of the

1934 Act was especially concerned with the impact of fraud on creditors.[17] Additionally, prosecution of securities fraud has frequently been brought under the mail fraud statute 18 U.S.C. §1341.[18] *See, e.g., U.S. v. Ashdown*, 509 F.2d 793 (5th Cir. 1975).

It should also be noted that SEC action is not the exclusive vehicle for redress from fraud in connection with securities transactions. For example, civil remedies are available under state law or the common law. *See SEC. v. Sloan, supra*, 56 L.Ed.2d at 159; *see also Blue Chip Stamps v. Manor Drug Stores, supra* at 738 n. 9. And if the SEC finds itself so insecure as to its power to regulate deceptive short selling, the SEC need only promulgate ad-

[17]Petitioner suggests that remedies under Rule 10b-5 may be undermined by the case at bar. Such a position ignores the fact that, as this Court has noted, the purpose and legislative history of the 1933 Act, in which Section 17(a)(1) is found, are quite distinguishable from those of the 1934 Act, under which Section 10(b) was enacted. The 1934 Act is general in scope and chiefly concerned with securities trading, whereas the 1933 Act is far narrower. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975); *see also Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). Further, the very language of Section 10(b) bespeaks an intent to protect more than investors. The provision prohibits activities in contravention of such rules and regulations as the SEC may prescribe "in the public interest" *or* "for the protection of investors". With a proscription of fraud "in connection with" a securities sale, rather than merely "in" a sale (as found in Section 17(a) of the 1933 Act), Section 10(b) is a "catch-all" against fraud related to securities transactions. *See Ernst & Ernst v. Hochfelder, supra* at 203.

[18]18 U.S.C. §1341 states in part:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . . for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Post Office Department, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both.

ditional regulations pursuant to Section 10(a) of the 1934 Act, which authorizes SEC regulation of short sales.

D. The Circuit Court's Decision is Consistent with the Language of Section 17(a)(1), Its Legislative Purpose and Prior Court Decisions.

The very face of Section 17(a)(1) plainly reflects that the statute affords protection only to investors. Only fraud "in" the sale of securities is prohibited.[19] A sale is defined to include "every contract of sale or disposition of a security." 15 U.S.C. §77b(3). The brokers who were allegedly deceived were not parties to any contract for sale or any disposition of securities, they were merely agents acting on behalf of Respondent. Only the actual purchasers of Respondent's sold securities were parties to Respondent's sales. However, such purchasers were neither deceived nor defrauded. Hence, there could have been no fraud "in" Respondent's sales.[20]

The Eighth Circuit's decision below is not only supported by the plain language of Section 17(a)(1), but by the Circuit Court's review of the legislative history of the 1933 Act. This history revealed a design to protect in-

[19]Petitioner on appeal chooses to focus on the fact that Section 17(a)(1) also proscribes fraud in the "offer" of a security (Petition at 7). Such approach does not surmount the basic obstacle that the Respondent did not either sell or make any offer to his brokers (Petition, App. A, 6a), Thus, there could have been no fraud "in" any offer. Further, the trial court found only that fraud had occurred in the actual "sale" of securities, with no reference to any offers (Petition, App. D, 20a). An offer is not included within the meaning of a "sale". *Blue Chip Stamps v. Manor Drug Stores, supra* at 733 n. 5.

[20]The language of Section 17(a) is to be sharply contrasted with the language of Section 10(b) under the 1934 Act and Rule 10b-5 which both broadly refer to fraud "in connection with" a sale of securities.

vestors only (Petition, App. A, 7a-8a).[21] Applying the strictures of Section 17(a)(1) only in cases of investor fraud is also consistent with the scope of other fraud provisions in the 1933 Act, such as Sections 11(a) and 12, 15 U.S.C. §§77k(a), 771, which establish civil liability only in the case of defrauded purchasers.[22]

Notwithstanding the unambiguous language of Section 17(a)(1) and the legislative policy and statutory scheme of the 1933 Act, Petitioner urges an expansion of Section 17 (a)(1) in view of the remedial purposes of the securities acts and in order to proscribe all potentially fraudulent activities. However, "this approach [is] unsatisfactory in its focus on situations that [Section 17(a)(1)] may not reach rather than on the language and purpose of the . . . provision itself."[23] *Foremost-McKesson, Inc. v. Provident Se-*

[21]By enacting the 1933 Act Congress sought:

> . . . To prevent further exploitation of the *public* by the sale of unsound, fraudulent and worthless securities through misrepresentation; to place adequate and true information before the *investor;* to protect honest enterprise . . . against the competition afforded by dishonest securities offered to the *public* through crooked promotion; to restore the confidence of the prospective *investor* in his ability to select sound securities . . .

S. Rep. No. 47, 73rd Cong., 1st Sess. 1 (1933) (Emphasis added).

[22]It is of interest to note that in *Piper v. Chris-Craft Indutsires, Inc.*, 430 U.S. 1, *reh. denied* — U.S. —, 52 (1977) this Court expressly acknowledged that certain provisions of the federal securities laws are designed and intended only to protect investors. There the Court held that a tender offeror did not have standing to sue for damages under Section 14(e) of the 1934 Act, 15 U.S.C. §77n(e), because the statute was designed to protect only investors who might be confronted with a tender offer.

[23]Petitioner's reliance on *United States v. Culbert*, — U.S. —, 55 L. Ed. 2d 349 (1978) is particularly misplaced. This decision is readily distinguishable since there defendant argued for a restriction as to the scope of a criminal statute where the statute was patently applicable and the argument was unsupported by the legislative history of the act.

curities Co., 423 U.S. 232, 244 (1976).[24] The Court should also be mindful of the well established rule that penal statutes are strictly construed. *Mourning v. Family Publication Service*, 411 U.S. 356, 375 (1973).

Petitioner has also attempted to manufacture a conflict between the Eighth Circuit's decision below and other cases. This endeavor is doomed, however, since this matter presents a case of first impression (Petition, App. A, 9a). Further, such decisions as are of any relevance to this matter, are consistent with the Eighth Circuit's conclusions. For example, although not in the short selling context, both the Fifth and Seventh Circuits have recognized that a required element for prosecution under Section 17 (a) is proof of an impact upon the investor:

> Specific reliance by the investor need not be shown in a prosecution under 15 U.S.C. §77(q)(a). Rather, what must be shown is that the scheme had an impact on the investor and that the mails were used in employing the scheme.

United States v. Ashdown, 509 F.2d 793, 799 (5th Cir. 1975); *Accord, United States v. Schaefer*, 299 F.2d 625, 629-30 (7th Cir. 1962).

The sole decision cited by Petitioner as a basis for an alleged conflict, *United States v. Brown*, 555 F.2d 336 (2d Cir. 1977), does not represent a conflict with the pending matter since the species of fraud involved there was

[24]In *Foremost-McKesson* a liberal interpretation was urged as to the scope of Section 16(b) of the 1934 Act, 15 U.S.C. §78p(b), which permits actions by an issuer for disgorgement of profits reaped by an insider's "short-swing" trading. Earlier expansive interpretations of Section 16(b) by circuit courts were expressly rebuked by the Supreme Court since "in none of the [Circuit Court] cases did the court examine critically the legislative history." 423 U.S. at 242. The Court was also unpersuaded by the contention that a restrictive interpretation of the statute would make it "inapplicable to some possible abuses." *Id.* at 244.

actually perpetrated against an investor. The defendant had counterfeited stock owned by a particular investor, thereby converting the investor's stock. *Id.* at 339. The Second Circuit expressly pointed out that the scheme included "a massive assault upon innocent investors." *Id.*

As a final backstop position, Petitioner apparently argues that investors in some manner are in fact injured if a broker suffers loss from a short sale buy-in. Petitioner argues that the risk of loss to the broker is ultimately shifted to the investing public by way of increased commissions or otherwise. Such position fails to acknowledge that civil and criminal actions may be brought other than under Section 17(a)(1) such that the case at bar imposes no additional risk of unrecouped loss to brokers. Additionally, with the buy-in requirements now imposed on sales transactions by Rule 15c3-3(m), any risk of significant buy-in losses is largely ameliorated.

CONCLUSION

The petition for a writ of certiorari in this matter should be denied.

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